CERNER CORP /MO/
Form 10-Q
August 05, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended: July 4, 2015
OR
( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ___________ to ___________

Commission File Number: 0-15386
CERNER CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	43-1196944
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
2800 Rockcreek Parkway North Kansas City, MO	64117
(Address of principal executive offices)	(Zip Code)

(816) 201-1024
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes [X] No [ ]
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes [X] No [ ]
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.
Large accelerated filer [X] Accelerated filer [ ] Non-accelerated filer [ ] Smaller reporting company [ ]
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes [ ] No [X]
Indicate the number of shares outstanding of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at July 28, 2015
Common Stock, $0.01 par value per share	345,074,144 shares

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CERNER CORPORATION

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Part I. Financial Information

Item 1. Financial Statements

CERNER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
As of July 4, 2015 (unaudited) and January 3, 2015

(In thousands, except share data)	2015	2014
Assets		
Current assets:		
Cash and cash equivalents	$293,979	$635,203
Short-term investments	264,074	785,663
Receivables, net	1,003,143	672,778
Inventory	28,633	23,789
Prepaid expenses and other	272,368	209,278
Deferred income taxes, net	21,510	22,075
Total current assets	1,883,707	2,348,786
Property and equipment, net	1,155,153	924,260
Software development costs, net	491,838	420,199
Goodwill	766,046	320,538
Intangible assets, net	720,583	126,636
Long-term investments	298,501	231,147
Other assets	169,005	158,999
Total assets	$5,484,833	$4,530,565
Liabilities and Shareholders’ Equity		
Current liabilities:		
Accounts payable	$208,734	$160,285
Current installments of long-term debt and capital lease obligations	55,448	67,460
Deferred revenue	274,223	209,655
Accrued payroll and tax withholdings	179,508	140,230
Other accrued expenses	59,938	56,685
Total current liabilities	777,851	634,315
Long-term debt and capital lease obligations	567,312	62,868
Deferred income taxes and other liabilities	250,825	256,601
Deferred revenue	24,852	10,813
Total liabilities	1,620,840	964,597
Shareholders’ Equity:		
Common stock, $.01 par value, 500,000,000 shares authorized, 349,496,088 shares issued at July 4, 2015 and 346,985,811 shares issued at January 3, 2015	3,495	3,470
Additional paid-in capital	1,018,194	933,446
Retained earnings	3,144,453	2,918,481
Treasury stock, 4,652,515 shares at July 4, 2015 and January 3, 2015	(245,333)	(245,333)

Accumulated other comprehensive loss, net	(56,816)	(44,096)
Total shareholders' equity	3,863,993	3,565,968
Total liabilities and shareholders' equity	$5,484,833	$4,530,565

See notes to condensed consolidated financial statements (unaudited).

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CERNER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
For the three and six months ended July 4, 2015 and June 28, 2014
(unaudited)

	Three Months Ended		Six Months Ended	
(In thousands, except per share data)	2015	2014	2015	2014
Revenues:				
System sales	$315,109	$234,563	$574,678	$441,250
Support, maintenance and services	792,827	588,167	1,511,197	1,145,596
Reimbursed travel	18,061	29,032	36,211	49,677
Total revenues	1,125,997	851,762	2,122,086	1,636,523
Costs and expenses:				
Cost of system sales	112,502	81,306	204,001	146,419
Cost of support, maintenance and services	61,759	52,031	120,770	95,372
Cost of reimbursed travel	18,061	29,032	36,211	49,677
Sales and client service	463,435	343,234	883,617	674,135
Software development (Includes amortization of $29,618 and $58,707 for the three and six months ended July 4, 2015; and $24,937 and $50,038 for the three and six months ended June 28, 2014)	138,451	97,326	265,722	188,871
General and administrative	135,545	53,971	230,356	105,957
Amortization of acquisition-related intangibles	24,508	3,229	42,761	6,456
Total costs and expenses	954,261	660,129	1,783,438	1,266,887
Operating earnings	171,736	191,633	338,648	369,636
Other income (expense), net	(1,079)	2,737	(871)	5,727
Earnings before income taxes	170,657	194,370	337,777	375,363
Income taxes	(55,619)	(65,337)	(111,805)	(126,804)
Net earnings	$115,038	$129,033	$225,972	$248,559
Basic earnings per share	$0.33	$0.38	$0.66	$0.73
Diluted earnings per share	$0.33	$0.37	$0.64	$0.71
Basic weighted average shares outstanding	344,431	341,788	343,880	342,787
Diluted weighted average shares outstanding	352,450	349,794	352,162	351,049

See notes to condensed consolidated financial statements (unaudited).

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CERNER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the three and six months ended July 4, 2015 and June 28, 2014
(unaudited)

	Three Months Ended		Six Months Ended	
(In thousands)	2015	2014	2015	2014
Net earnings	$115,038	$129,033	$225,972	$248,559
Foreign currency translation adjustment and other (net of taxes (benefit) of $(863) and $(2,229) for the three and six months ended July 4, 2015; and $(48) and $319 for the three and six months ended June 28, 2014)	5,616	5,042	(12,894)	8,069
Unrealized holding gain (loss) on available-for-sale investments (net of taxes (benefit) of $(132) and $113 for the three and six months ended July 4, 2015; and $(55) and $7 for the three and six months ended June 28, 2014)	(212)	(85)	174	12
Comprehensive income	$120,442	$133,990	$213,252	$256,640

See notes to condensed consolidated financial statements (unaudited).

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CERNER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the six months ended July 4, 2015 and June 28, 2014
(unaudited)

(In thousands)	Six Months Ended 2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net earnings	$225,972	$248,559
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	213,513	141,806
Share-based compensation expense	34,451	28,269
Provision for deferred income taxes	2,866	2,687
Changes in assets and liabilities (net of businesses acquired):		
Receivables, net	(130,242)	(15,218)
Inventory	423	579
Prepaid expenses and other	(37,951)	11,717
Accounts payable	(4,069)	(518)
Accrued income taxes	(4,667)	(4,864)
Deferred revenue	1,139	17,801
Other accrued liabilities	21,476	(26,760)
Net cash provided by operating activities	322,911	404,058
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital purchases	(167,134)	(131,997)
Capitalized software development costs	(132,864)	(86,666)
Purchases of investments	(317,890)	(500,903)
Sales and maturities of investments	766,017	572,293
Purchase of other intangibles	(6,895)	(7,190)
Acquisition of businesses	(1,372,014)	(7,476)
Net cash used in investing activities	(1,230,780)	(161,939)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Long-term debt issuance	500,000	—
Repayment of long-term debt and capital lease obligations	—	(69)
Proceeds from excess tax benefits from share-based compensation	52,075	20,642
Proceeds from exercise of options	32,832	14,175
Treasury stock purchases	—	(217,082)
Contingent consideration payments for acquisition of businesses	(11,012)	—
Cash grants	—	48,000
Other	(791)	2,894
Net cash provided by (used in) financing activities	573,104	(131,440)
Effect of exchange rate changes on cash and cash equivalents	(6,459)	2,204
Net increase (decrease) in cash and cash equivalents	(341,224)	112,883

Cash and cash equivalents at beginning of period	635,203	202,377
Cash and cash equivalents at end of period	$293,979	$315,260
Summary of acquisition transactions:		
Fair value of tangible assets acquired	$451,881	$184
Fair value of intangible assets acquired	637,980	3,800
Fair value of goodwill	449,023	16,785
Less: Fair value of liabilities assumed	(166,870)	(1,693)
Less: Fair value of contingent liability payable	—	(11,600)
Net cash used	$1,372,014	$7,476

See notes to condensed consolidated financial statements (unaudited).

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CERNER CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(1) Interim Statement Presentation

Basis of Presentation

The condensed consolidated financial statements included herein have been prepared by Cerner Corporation (Cerner, the Company, we, us or our) without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in our latest annual report on Form 10-K.

In management's opinion, the accompanying unaudited condensed consolidated financial statements include all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position and the results of operations and cash flows for the periods presented. Our interim results as presented in this Form 10-Q are not necessarily indicative of the operating results for the entire year.

The condensed consolidated financial statements were prepared using GAAP. These principles require us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses. Actual results could differ from those estimates.

Fiscal Period End

Our 2015 and 2014 second quarters ended on July 4, 2015 and June 28, 2014, respectively. All references to years in these notes to condensed consolidated financial statements represent the respective three or six months ended on such dates, unless otherwise noted.

Factors Impacting Comparability of Interim Financial Statements

Siemens Health Services

On February 2, 2015, we acquired Siemens Health Services, as further described in Note (2). The addition of the Siemens Health Services business has a significant impact on the comparability of our condensed consolidated financial statements as of and for the three and six months ended July 4, 2015, in relation to the comparative periods presented herein.

Amortization of Acquisition-related Intangibles

Amortization of acquisition-related intangibles includes the amortization of customer relationships, acquired technology, trade names, and non-compete agreements recorded in connection with our business acquisitions. Historically, such amounts were included in general and administrative expense in our condensed consolidated statements of operations. Effective for our second quarter of 2015, amortization of acquisition-related intangibles is presented on a separate line within our condensed consolidated statements of operations. While this reporting change did not impact our consolidated results, prior period reclassifications have been made to conform to the current period presentation.

Acquisition Transactions within our Condensed Consolidated Statements of Cash Flows

Historically, the fair value of tangible assets acquired and liabilities assumed in business acquisitions were presented on a net basis within our condensed consolidated statements of cash flows. Effective for our first quarter of 2015, the fair value of tangible assets acquired and the fair value of liabilities assumed are presented separately. While this reporting change did not impact our consolidated results, prior period reclassifications have been made to conform to the current period presentation.

Voluntary Separation Plan

In the first quarter of 2015, the Company adopted a voluntary separation plan ("VSP") for eligible associates. Generally, the VSP was available to U.S. associates who met a minimum level of combined age and tenure, excluding, among others, our

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executive officers. Associates who elected to participate in the VSP receive financial benefits commensurate with their tenure and position, along with vacation payout and medical benefits.

We account for voluntary separation benefits in accordance with the provisions of Accounting Standards Codification (ASC) Topic 712, Compensation-Nonretirement Postemployment Benefits. Voluntary separation benefits are recorded to expense when the associates irrevocably accept the offer and the amount of the termination liability is reasonably estimable. The irrevocable acceptance period for most associates electing to participate in the VSP ended in May 2015. In the second quarter of 2015, we recorded a pre-tax charge for the VSP of $42 million, which is included in general and administrative expense in our condensed consolidated statements of operations. We expect to record additional pre-tax charges for the VSP during the remainder of 2015 of approximately $4 million, in the aggregate.

Recently Issued Accounting Pronouncements

Revenue Recognition. In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP. The new standard is effective for the Company in the first quarter of 2018. The standard permits the use of either the retrospective or cumulative effect transition method. At this time, we have not selected a transition method. We are currently evaluating the effect that ASU 2014-09 will have on our consolidated financial statements and related disclosures.

Debt Issuance Costs. In April 2015, the FASB issued ASU 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs, which requires that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying value of the debt liability. ASU 2015-03 is effective for the Company in the first quarter of 2016, with early adoption permitted, and retrospective application required. The Company has chosen to adopt the standard early, effective in the first quarter of 2015. The adoption of ASU 2015-03 did not have a material impact on our condensed consolidated financial statements. Refer to Note (9) for further information regarding debt issuance costs.

Consolidation. In February 2015, the FASB issued ASU 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis, which provides guidance when evaluating whether to consolidate certain legal entities. The updated guidance modifies evaluation criteria of limited partnerships and similar legal entities, eliminates the presumption that a general partner should consolidate a limited partnership, and affects the consolidation analysis of reporting entities that are involved with variable interest entities, particularly those that have fee arrangements and related party relationships. ASU 2015-02 is effective for the Company in the first quarter of 2016, with early adoption permitted. We are currently evaluating the effect that ASU 2015-02 will have on our consolidated financial statements and related disclosures.

(2) Business Acquisitions

Siemens Health Services

On February 2, 2015, we acquired substantially all of the assets, and assumed certain liabilities of Siemens Health Services, the health information technology business unit of Siemens AG, a stock corporation established under the laws of Germany, and its affiliates. Siemens Health Services offered a portfolio of enterprise-level clinical and financial health care information technology solutions, as well as departmental, connectivity, population health, and care coordination solutions globally. Solutions were offered on the Soarian®, Invision®, and i.s.h.med® platforms, among others. Siemens Health Services also offered a range of complementary services including support, hosting, managed services, implementation services, and strategic consulting.

We believe the acquisition enhances our organic growth opportunities as it provides us a larger base into which we can sell our combined portfolio of solutions and services. The acquisition also augments our non-U.S. footprint and growth opportunities, increases our scale for R&D investment, and adds over 5,000 highly-skilled associates that will enhance our capabilities. These factors, combined with the synergies and economies of scale expected from combining the operations of Cerner and Siemens Health Services, are the basis for the acquisition and comprise the resulting goodwill recorded.

Consideration for the acquisition was $1.37 billion of cash, consisting of the $1.3 billion agreed upon purchase price plus working capital adjustments. The purchase price is subject to certain post-closing adjustments for working capital and pension obligations, as specified in the Master Sale and Purchase Agreement dated August 5, 2014, as amended.

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During the six months ended July 4, 2015, we incurred $20 million of pre-tax acquisition costs in connection with the acquisition of Siemens Health Services, which are included in general and administrative expenses in our condensed consolidated statements of operations.

The acquisition of Siemens Health Services is being treated as a purchase in accordance with ASC Topic 805, Business Combinations, which requires allocation of the purchase price to the estimated fair values of the assets acquired and liabilities assumed in the transaction. Our allocation of purchase price is based on management's judgment after evaluating several factors, including a preliminary valuation assessment. The allocation of purchase price is preliminary and subject to changes, which could be significant, as appraisals of tangible and intangible assets are finalized, working capital and pension obligation adjustments are agreed upon and finalized, and additional information becomes available.

The preliminary allocation of purchase price is as follows:

(in thousands)	Allocation Amount	Estimated Weighted Average Useful Life
Receivables, net of allowances of $33,674	$236,491	
Other current assets	56,859	
Property and equipment	158,298	20 years
Goodwill	449,023	
Intangible assets:		
Customer relationships	396,000	10 years
Existing technologies	201,990	5 years
Trade names	39,990	8 years
Total intangible assets	637,980	
Other non-current assets	233	
Accounts payable	(42,076)	
Deferred revenue (current)	(90,148)	
Other current liabilities	(19,716)	
Deferred revenue (non-current)	(14,930)	
Total purchase price	$1,372,014	

The intangible assets in the table above are being amortized on a straight-line basis over their estimated useful lives, with such amortization included in amortization of acquisition-related intangibles in our condensed consolidated statements of operations.

The fair value measurements of tangible and intangible assets and liabilities were based on significant inputs not observable in the market and thus represent Level 3 measurements within the fair value measurement hierarchy. Level 3 inputs included, among others, discount rates that we estimated would be used by a market participant in valuing these assets and liabilities, projections of revenues and cash flows, client attrition rates, royalty rates, and market comparables.

Property and equipment was valued primarily using the sales comparison method, a form of the market approach, in which the value is derived by evaluating the market prices of assets with comparable features such as size, location, condition and age. Our analysis included multiple property categories, including land, buildings, and personal property and included assumptions for market prices of comparable assets, and physical and economic obsolescence, among others.

Customer relationship intangible assets were valued using the excess earnings method, a form of the income approach, in which the value is derived by estimation of the after-tax cash flows specifically attributable to the customer relationships. Our analysis consisted of two customer categories, order backlog and existing customer relationships and included assumptions for projections of revenues and expenses, contributory asset charges, discount rates, and a tax amortization benefit, among others.

Existing technology and trade name intangible assets were valued using the relief from royalty method, a form of the income approach, in which the value is derived by estimation of the after-tax royalty savings attributable to owning the assets.

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Assumptions in these analyses included projections of revenues, royalty rates representing costs avoided due to ownership of the assets, discount rates, and a tax amortization benefit.

Deferred revenue was valued using an income approach, in which the value was derived by estimation of the fulfillment cost, plus a normal profit margin (which excludes any selling margin), for performance obligations assumed in the acquisition. Assumptions included estimations of costs incurred to fulfill the obligations, profit margins a market participant would expect to receive, and a discount rate.

The goodwill of $449 million was allocated among our Domestic and Global operating segments, as shown below, and is expected to be deductible for tax purposes.

The changes in the carrying amounts of goodwill for the six months ended July 4, 2015 were as follows:

(In thousands)	Domestic	Global	Total
Beginning balance	$311,170	$9,368	$320,538
Goodwill recorded in connection with the Siemens Health Services acquisition	386,663	62,360	449,023
Foreign currency translation adjustments and other	—	(3,515)	(3,515)
Ending balance at July 4, 2015	$697,833	$68,213	$766,046

Our condensed consolidated statements of operations for the three and six months ended July 4, 2015 include revenues of approximately $260 million and $435 million, respectively, attributable to the acquired business (now referred to as "Cerner Health Services") since the February 2, 2015 acquisition date. Disclosure of the earnings contribution from the Cerner Health Services business is not practicable, as we have already integrated operations in many areas.

The following table provides unaudited pro forma results of operations for the three and six months ended July 4, 2015 and June 28, 2014, as if the acquisition had been completed on the first day of our 2014 fiscal year.

	Three Months Ended		Six Months Ended	
(In thousands, except per share data)	2015	2014	2015	2014
Pro forma revenues	$1,125,997	$1,144,861	$2,215,766	$2,210,662
Pro forma net earnings	117,047	115,043	231,379	213,132
Pro forma diluted earnings per share	0.33	0.33	0.66	0.61

These pro forma results are based on estimates and assumptions, which we believe are reasonable. They are not the results that would have been realized had we been a combined company during the periods presented, nor are they indicative of our consolidated results of operations in future periods. The pro forma results for the three months ended July 4, 2015 include a pre-tax adjustment to eliminate $3 million of acquisition costs. The pro forma results for the six months ended July 4, 2015 include pre-tax adjustments for amortization of intangible assets, fair value adjustments for deferred revenue, and the elimination of acquisition costs of $7 million, $6 million and $20 million, respectively. Pro forma results for the three months ended June 28, 2014 include pre-tax adjustments for amortization of intangible assets and fair value adjustments for deferred revenue of $22 million and $7 million, respectively. The pro forma results for the six months ended June 28, 2014 include pre-tax adjustments for amortization of intangible assets and fair value adjustments for deferred revenue of $43 million and $25 million, respectively.

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(3) Fair Value Measurements

We determine fair value measurements used in our consolidated financial statements based upon the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value hierarchy distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are described below:

- Level 1 – Valuations based on quoted prices in active markets for identical assets or liabilities that the entity has the ability to access.
- Level 2 – Valuations based on quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable data for substantially the full term of the assets or liabilities.
- Level 3 – Valuations based on inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The following table details our financial assets measured and recorded at fair value on a recurring basis at July 4, 2015:
(In thousands)

		Fair Value Measurements Using		
Description	Balance Sheet Classification	Level 1	Level 2	Level 3
Money market funds	Cash equivalents	$67,104	$—	$—
Time deposits	Cash equivalents			